DOW THEORY LETTERS INC.

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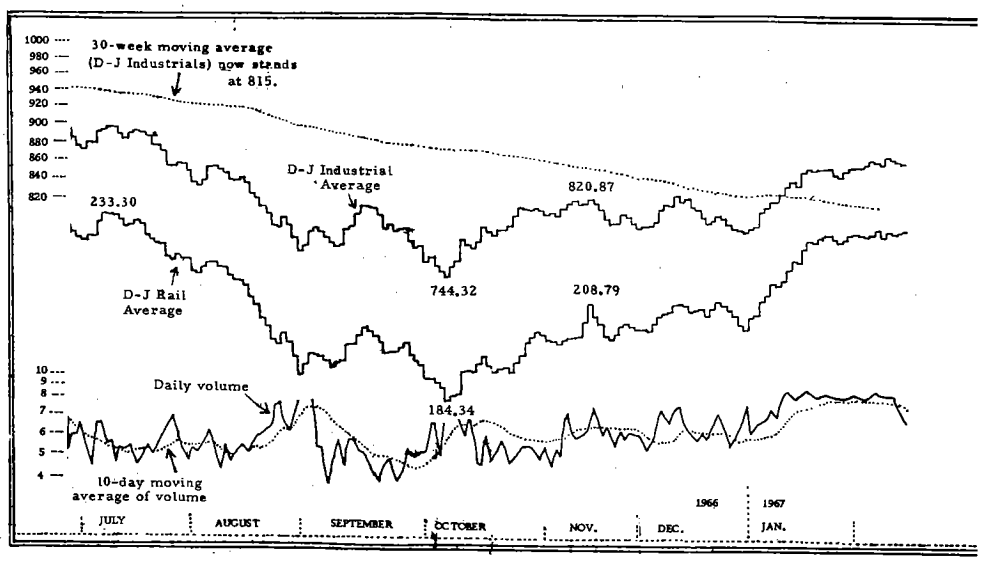
THE MARKET: There is no "formula" with which to predict the probable extent or duration of the first major recovery following a primary bear market smash. Between September, 1929 and the crash low of November, 1929, the Industrial Average lost 183 points. The famous recovery into April, 1930, retraced just under 53% of the 1929 losses. Following this the Averages turned down again, entering a long decline which was not to end until July, 1932 at 41.22 on the Dow. It was 22 years later, in 1954, that the Dow finally bettered its 1929 highs.

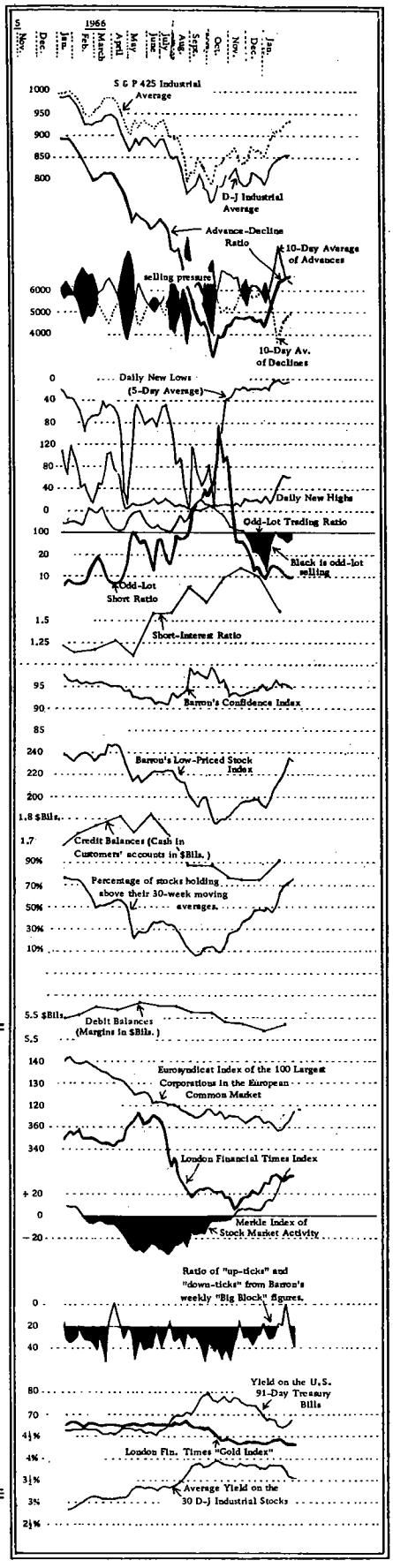
In March, 1937, the Industrial topped out at 194.40. By March, 1938, the Dow had dropped to 98.95, one of the worst one-year declines in history. By November, 1938, the Dow had recovered to 158.41. The explosive 1938 advance succeeded in recovering 62% of the 1937-38 losses. Following the 1938 high, the Averages turned down in a long tortuous decline which did not touch bottom until April, 1942, at 92.92 for the Industrial Average.

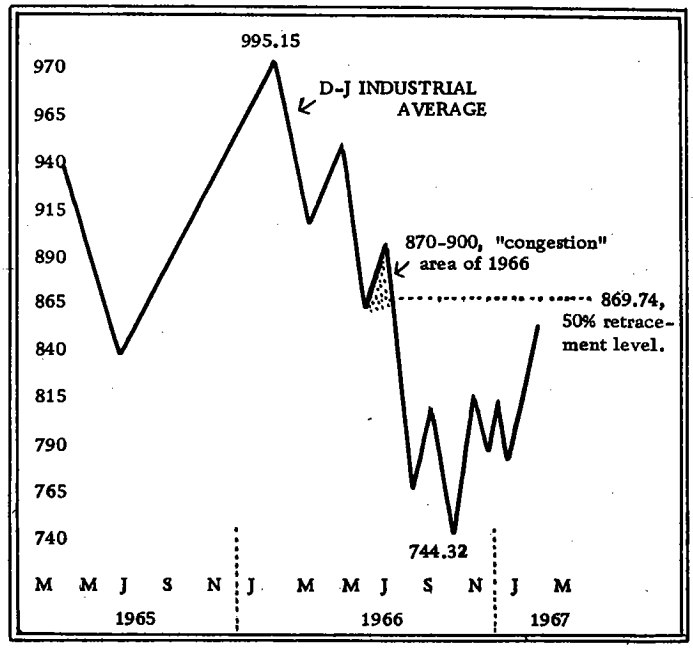
Thus we have the record of two great recoveries following two great initial bear market collapses. Neither recovery took the Dow back to the old highs, although both recoveries generated great hopes and expectations. Both recoveries were followed by extended resumptions of the primary bear trend.

The 1966 market break erased 250 points from the Industrial Average. A 50% recovery (comparable to the 1929-30 recovery) would take the Dow back to the 870 area. A 62% recovery (comparable to 1937-38) would bring the Dow back to around 900. There isn't a man alive who can predict whether the Dow will now duplicate the 1929-30 advance or the 1937-38 advance — or whether the Dow will even do better in this bear market recovery than it did during 1937-38.

What we can say is that every recovery (or secondary upward reaction) in a bear market is liable to retrace approximately one-third to two-thirds of the ground lost during the preceding primary bear movement. During the summer and fall of 1966 I reminded subscribers that sooner or later this bear market would generate a secondary correction which would recoup one-third to two-thirds of all the ground lost during 1966. Obviously, we are witnessing such a recovery now.




1966
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio
10-Day Average of Advances
selling pressure
10-Day Av. of Declines
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
Ratio of "up-ticks" and "down-ticks" from Barron's weekly "Big Block" figures.
Yield on the U.S. 91-Day Treasury Bills
London Fin. Times "Gold Index"
Average Yield on the 30 D-J Industrial Stocks



I have drawn a chart depicting the action of the Industrial Average from 1965 to the present. This chart should help subscribers to get a clearer view of the big picture. Note that a 50% recovery of the entire drop from 995.15 (February, 1966) to 744.32 (October, 1966) would bring the Dow back to 869.73. A 50% retracement would be normal enough, but I would expect a good deal of resistance to start to show at the halfway level. Not only does important resistance often occur at the halfway level of a recovery in a bear market, but the area from 870 to 900 corresponds to the May-June-July "congestion" area of 1966. It was there that stocks "churned about" for almost three months, then dropped precipitously to the October lows. The 870-900 area on the chart is shown as a shaded section.

I have been mentioning the record volume which has appeared on the New York Stock Exchange since mid-January. The chart of the Averages shown on page 1 is drawn to semi-logarithmic scale. Thus it depicts movement in terms of percentages (a rise from 400 to 800 on the Dow would show up as exactly the same distance as a rise from 500 to 1000). Note on this chart that the December-January advance lost much of its upside momentumaround the middle of January. Since then, volume has been tremendous but the percentage of rise is much reduced. This type of action (see last Letter) strongly suggests "churning", a process in which stocks are distributed under the guise of furious activity.

I have received many inquiries regarding the huge volume of 1967. In my opinion, a good deal of this volume stems from the now highly-speculative activity of certain funds, particularly the competition-minded "performance funds." It is well known that these funds act very much like giant "traders," jumping in for a few points here, a small profit there. Furthermore, with the "computerization" of Wall Street via a number of investment services, there is an increasing segment of the investment fraternity which now goes for "action" and "motion." It should be remembered that computers show which stocks are moving, and it is the "action" stocks which the computer-followers want. Thus, a stock that might have comsumed 10 months in rising 25% a few years ago, now completes the same rise in a matter of a month or so. The computers pick it out, traders rush in, and the movement is over in a hurry.

Conclusion: The primary trend of the market is bearish. The secondary trend turned bullish in October, and since then the market has mounted a major recovery under direct stimulus of almost weekly "shots" and "hypos" from the Administration. A great deal of importance is now being attached to the "new lower interest rates," but this writer believes it a fallacy to equate business and market activity directly with interest rates (i.e. if rates are high business slumps, if they are low, business booms). The current decline in interest rates may send the U.S. economy in orbit again, but I believe that the high interest rates of 1966-67 are merely a symtom of the termination of the boom.

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All of which brings me to this point; I have seldom seen a time when the economists were so at odds with each other. All opinions are hedged by an "if the Vietnam war ends." According to Newsweek certain secret negotiations are now in progress regarding termination of the war, but even if the war does end there is wide disagreement about what this may mean for the market or the economy. Most believe that an ending of the war would be short-term bearish, long-term bullish. However, I want to warn subscribers never to underestimate the discounting ability of the market. It has occurred to me that much of the current market rise could be an attempt to discount the war's end, and that an actual announcement of the end of the war could amount to "the good news coming out." If so, investors would sell on the news, thereby writing an end to the rise and bringing about a wide-open smash.

The Counsel of Economic Advisors foresees a slow first half of 1967 and an increase in business thereafter. But even here there is much disagreement, with many economists, including such highly regarded analysts as Anthony Gaubis of New York and Harold Dorsey (Argus Research), believing that there is a fair chance of a decline in economic activity during the second half of the year. Since this is a primary bear market, I would be inclined to agree with Gaubis and Dorsey regarding the prospects for the second half of 1967.

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Incidentally, I believe there is room for much doubt regarding a settlement of the Vietnam war any time soon. The U.S. has suspended (probably temporarily) bombing of North Vietnam in the hopes of bringing a counter move from Hanoi. But the facts are (1) The Communists used the recent "cease fire" as an opportunity to build up supplies. This strongly suggests that they mean to continue fighting. (2) The U.S. has been doing better on the military front recently. The U.S. cannot risk a military "loss of face," and LBJ will probably press whatever advantage he can gain out of the current U.S. "successes." (3) Russia wants the war to continue, since it keeps the U.S. "aimed" continually at Russia's real enemy, China. (4) DeGaulle wants the war to continue, at least for a while, because it is so damaging to U.S. prestige— at a time when DeGaulle wants his own way in Europe.

TIME BOMB: Many subscribers have asked me why, during the 250 point drop of 1966, the market did not reach the "panic stage." My only answer is that investors throughout the nation seemed to have reached a state of fantastic complacency. Think of it, today's

young brokers and their clients of 40 years of age and under have never seen a bear market. At no other time in Wall Street annals could that statement have been made.

American history has been punctuated by bear market panics from the time of the Revolution to the late 1930's. Most of the earlier panics (bear markets) were a result of natural causes. These were the days when America was primarily an agricultural nation, and a crop failure or an earthquake could set the entire nation's economy on end. After 1850 most of the bear markets were caused by industrial crisis, often brought on by railroad failures, financial panics, the collapse of a large corporate enterprise or a sudden outflow of gold.

After 1890 speculative panics during bear markets were commonly seen, and for instance, the panics of 1902, and the bear markets of 1907, 1937, and 1929 contained a large speculative element in their makeup. So common was the spectacle of bear market collapse in early American history that Charles Dow in his Wall Street Journal editorial entitled "The Recurrence of Crisis," put forth his concept of the "10-year cycle of panic." Dow listed the following as panic years, 1701, 1711, 1731, 1742, 1763, 1772-73, 1793, 1804-5, 1815, 1825, 1836, 1847, 1857, 1866, 1878.

FRANCE & ENGLAND: Britain, as DeGaulle sees it, is outside the European community. The European Community is rich and debt free. England is inefficient and in debt. Although one-third of the world's trade is transacted in Britain's sterling, the pound is still fundamentally weak. The reserves of the sterling block are kept mainly in London. But the debts of Britain already exceed its reserves.

Britain now wants to join the European Community. But Europe and Britain have vastly different ideas about international finance. If Britain joins Europe, its debts will have to be assumed by Europe in the end (unless Britain can remain "in recession" and run endless surpluses).

But there is an alternative, says DeGaulle. Britain might join the European Common Market if Britain can come to an understanding with France regarding a new international monetary system. That system was explained by Jacques Rueff. France, Germany and the other European nations are now heavy in "real money" — gold. France advocates doubling the price of gold, then having Britain (and presumably the U.S.) pay off its debts with its new doubled reserves. Finally, France wants to pay off all international debts as they accrue, in real money— gold. Thus, dollars and pounds would not be allowed to accumulate in a nation's reserve system, to be counted "as good as gold." There is only one thing as good as gold, DeGaulle believes, and that is gold. The next nearest thing to gold is a fully convertible currency which can be exchanged for gold at any time. Such a currency is the franc, which is now fully convertible. DeGaulle is saying that the franc is now one of the finest currencies in the world. It is heavily backed by gold and is fully convertible. As such, it is superior to the pound and the dollar.

DeGaulle is counting on his knowledge of history and basic fundamentals to win his battle for him. DeGaulle understands the truth of the old adage, "Gold always wins." He knows that a powerful small France with heavy gold reserves can do battle and perhaps beat a weak huge United States with dwindling gold reserves. He believes that in the end Britain will go where its best interests lie. DeGaulle believes that Britain will accept the economic health and power of Europe rather than the deficit-ridden, restricted economic partnership of the U.S.

CONCLUSION: Britain is in debt and France is not. DeGaulle is saying, "We will accept you and your debts in the European Community if you will play the game according to our rules. If you can't support our policies, then we will accept you only when your debts are paid off and you are financially solvent."

France signed the Treaty of Rome. Under that Treaty, it requires only one vote to say "No." DeGaulle knows the rules, and he is waiting. He has yet to make a fundamental mistake in his plan for a new, powerful, solvent European Community.

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The following, by economist Melchior Palyi, is most interesting. It refers to the current U.S. practice of moving short-term U.S. debt (debt is anything of 365 days or under) up to 366 days or more, which makes it a "foreign investment."

Says Palyi, "Under Louis XVI, France was headed for national bankruptcy. A very able minister of finance by the name of Necker had a brilliant idea to save the credit of the government; he falsified the budget. The deficit disappeared, but not for long, with the final payoff being the Great Revolution.

"Two hundred years later, bookkeeping tricks are being used in the United States to camouflage financial distress. We are referring to the official manipulation of our balance of payments figures. For 1966, the complete data is not available as yet. But it is apparent that some 2½ billion dollars left the country in excess of the dollars which came in."

Actually, there has never (until the present) been a period of 10 years or more when the nation was fortunate enough to escape financial collapse. This gave rise to a certain conservatism and the habit of "saving for a rainy day." Not only was saving considered a blessing, but going into debt was considered an evil to be avoided. As late as 1929, in fact, Government was actively attempting to lower the national debt (which was reduced from $21 billion in the early 1920's to $16 billion in 1929).

With the Great Depression of the 1930's and the introduction of Keynesian philosophy and the New Deal, the concept of deficit spending gained acceptance. Each succeeding Administration tacked on its own brand of deficit spending, together with such crowd-pleasing labels as the Fair Deal, the New Frontier, the Great Society and the New Economics.

From the Keynesian concept of running up deficits in time of depression and then paying off those deficits in time of prosperity, the New Economics has changed the game to one of running up deficits in both good time and bad. The result has been an absolute orgy of spending and deficits. Today the annual interest on the national debt ($14 billion) is almost as large as the entire national debt of 1929 ($16 billion).

Through the mechanism of a titanic rise in debt in all segments of the economy, the nation has avoided a "showdown" for a quarter of a century. Since 1940 no major bear market has arrived to jar the investor or to shake the national consciousness. And along with the absence of depression came confidence— an almost unshakable confidence in the ability of government to guide the economy ever onward and upward.

Following the lead of their Government, the rest of the U.S. since 1940 has plunged headlong into debt. The states, the counties, the municipalities and the cities have moved into debt. All the while, the American people themselves have increasingly embraced the debt route. No longer does one wait until one has the money to pay for what he wants; he buys it now "and pays later." All of

 which results in a mounting tower of fixed debt, debt which must be serviced in terms of interest. For along with debt comes higher interest rates.

The first severe spate with interest rates came in 1958, but this was quickly overcome via the printing presses. The second onslought came in 1960 (see last Letter), but again the Government "eased up" on money rates. The latest tide of rising money rates came in 1966, But this time, by all accounts, the U.S. narrowly avoided a money panic.

Now, in 1967, we sense "something different" in the wind. The high money rates of 1966 have eased at this writing, but they have not eased by anything like that which was seen in 1958 to 1960. Indeed, today's 91-day Treasury bill rate of 4.5% and today's bank prime rate of 5 1/2 to 5 3/4% is still high in the light of recent history. And the reason why is plain to see. Aside from the current towering expenses of Vietnam, look at the record of the recent 89th Congress. That Congress passed 21 new health programs, 17 new educational programs, 15 economic-development programs, 12 new programs for cities and 17 new resource-development programs.

Senator Muskie of Maine recently noted that there are now 170 different federal-aid programs on the books, financed by more than 400 separate appropriations, and administered by 21 federal departments and agencies aided by 150 Washington bureaus and more than 400 regional offices. The immense spending apparatus has grown so complicated that according to James Reston (of the N.Y. Times) even Democrats are now complaining about Administration confusion and inefficiencies.

This has led to a rather interesting speculation on my part. Up to now, every bear market in American history has been brought on by trouble in the private sector of the economy. I wonder if the current bear market is not going to be brought to its panic stage by a breakdown in the public sector of the nation, augmented by later panic among private citizens when they see their Government embroiled in a great financial bind.

It seems apparent that it is going to take some great and unexpected event to scare American investors out of their stocks during this bear market. The spectacle of a 26% drop in the Dow during 1966 did not result in panic (the same percentage drop in 1962 did bring on panic conditions). What will produce the "crack" which will be heard around the world during this bear market? I believe it could be a breakdown in Government finances, and a collapse in Government debt-handling abilities. Time alone will tell.

STOCKS: I find it particularly interesting to study the long-term charts of two great American corporations, two great profit-generating giants, DuPont and General Motors.

All through the bull market from 1949 to 1966 these two stocks led on the upside. Following each secondary reactions such as 1953, 1957, 1960, 1962, DD and GM could be counted upon to lead the way to higher ground. Big investment money was coming into the market, and the thinking was that any renewed prosperity had to "rub off" on GM and DD. If GM and DD did not benefit from an economic upturn, there simply wasn't going to be an economic upturn.

Now for the first time DD and GM are extremely sluggish on a market advance. The weekly charts (courtesy of Traders Research, 101 Cherry St., Alton, Illinois 62003) show that the rise in both GM and DD is negligible, compared with the major collapses which were seen in 1966. Relative market strength in both of the "bellwether" issues is near the low of the past four or five years. I believe that GM and DD are now strongly responding to the primary bear trend. I feel that they could be subtly leading the way down for the entire market.